PHASE II REPORT
ELIGIBLE REFINER OIL RIK PROGRAM

by

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Background

In June 1996 the Royalty Policy Committee recommended that the Minerals Management Service (MMS) review the oil Royalty-in-Kind program (RIK) stating that "The current method of administering the Federal oil RIK program is time consuming and burdensome on producers, small refiners and MMS." In response to both that recommendation and internal management needs, MMS formed a team to study ways to improve the program. An MMS internal report, issued in September 1997 entitled "Oil RIK Value and Volume Reporting Recommendations," addressed the results and recommendations of the first phase of the study. The report recommended a pilot effort to evaluate various options for improving RIK valuation, delivery, and reporting.

Also, during the first phase of the study, we identified a number of other existing RIK processes holding promise for improvement and streamlining. We selected three such processes for evaluation in a second study phase:

-- the RIK Determination of Need process,
-- the methodology used to determine RIK administrative fees, and
-- the use of Payor Selling Arrangements in the monthly RIK invoicing process.

DETERMINATION OF NEED

Authority

Regulatory language governing the Determination of Need process is found at 30 CFR 208.4(a). "The Secretary <u>may</u> (emphasis added) evaluate crude oil market conditions from time to time. The evaluation will include, among other things, the availability of crude oil and the crude oil requirements of the Federal Government, primarily those requirements concerning matters of national interest and defense. The Secretary will review these items and will determine whether eligible refiners have access to adequate supplies of crude oil and whether such oil is available to eligible refiners at equitable prices. Such determinations may be made on a regional basis. The determination by the Secretary shall be published in the FEDERAL REGISTER concurrent with or included in the 'Notice of Availability of Royalty Oil' required by 30 CFR 208.5."

General Accounting Office (GAO) Report of 1985[1]

It is important to note that the regulatory language establishes only a discretionary action in conducting a Determination of Need as opposed to establishing a Secretarial mandate. This point was affirmed in the only external oversight evaluation performed on the RIK program. In 1985 the GAO issued its report on the RIK program and noted that governing statutes (i.e., the *Outer Continental Shelf Lands Act of 1953 (OCSLA), and the Mineral Leasing Act of 1920 (MLA)* do not establish either specific action or criteria for conducting a Determination of Need. The report conceded that key terms like "sufficient," "adequate," and "equitable" were left undefined, essentially leaving it to the Secretary to make these interpretations.[2]

The 1985 GAO report also affirmed the propriety of "regional" determinations in the context of onshore RIK sales. In other words, there was nothing in the law that precluded the Secretary from conducting a sale in the Western United States if he believed that the situation in that geographic region warranted a sale.[3]

Even though the OCSLA and MLA define the intended program beneficiaries differently[4]--i.e., recipients of OCS royalty oil must be "small" refiners (per the Small Business Administration (SBA) definition) who lack access to adequate supplies of crude oil at fair market prices, while onshore recipients must be "independent" refiners having difficulty obtaining sufficient stocks in the open market--the GAO found that the Secretary nevertheless had made the required determinations by saying that "small refiners as a class"[5] continue to have difficulty getting ongoing supplies of reasonably priced crude to run their refineries. GAO acknowledged the difficulty of developing and

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[1] GAO Report to the Chairman, Subcommittee on Oversight and Investigations, Committee of Energy and Commerce, House of Representatives, "Reasons and Current Outlook for the Sale of Federal Royalty Oil to Small and Independent Refiners," GAO-RCED-85-129, August 26, 1985.

[2] Ibid., Chapter 2, p. 9.

[3] Ibid., Chapter 3, pp. 18-19.

[4] Ibid., Digest, p. i; Chapter 3, p. 19.

[5] Ibid., Chapter 2, p. 10.

documenting marketplace conditions satisfying the different legal criteria.[6]

When further pressed for the rationale behind the 1983 sales, the then Director, MMS, stated that it was Interior's belief that Congress intended to use the royalty oil program as "an underpinning for a viable independent refining industry." With that as the overriding legislative mandate, he concluded that, "Constancy of supply and reasonable price are the criteria, nothing more is needed."[7]

Historical Perspective

In past practice, the Determination of Need process has, with one notable exception, been largely an informal process reacting primarily to expressions of interest from small refiners not already participating in the program as well as indications from participating refiners of their continued interest in the program. (In the past, we have also received formal expressions of interest from Congressmen on behalf of their refiner constituents--inquiries that we have also factored into the decisionmaking process.)

This clearly was the process employed prior to the RIK sales held in 1983, 1987, and 1994. The one notable exception was a Determination of Need conducted in 1992 where a structured, documented effort was completed in evaluating the extent to which refiners had access to adequate supplies of crude oil at equitable prices. Even the determination conducted in 1992 had some questionable factors associated with it because there were questions about the need for program continuance in the context of diminished interest by the small refiner community.

Refiner Input

As part of our analysis of Determination of Need, we solicited input from several RIK refiners currently participating in the program. Key items of feedback, which we received at a special meeting on December 4, 1997, include:

a) the caveat that MMS should not construe dwindling program participation as reflective of lack of need or interest in the program--several factors, including the ongoing risk of

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[6]Ibid., Chapter 3, p. 19.

[7]Ibid., Appendix IV.

retroactive price adjustments, declining RIK production volumes, etc., have forced many companies to terminate their contracts, but they strongly feel that lack of need is **not** among those factors;

b) MMS should maintain the program because there is no cost or revenue risk to the Federal Government--i.e., the program is wholly funded by participants through the administrative fee, and revenues equal what is realized through in-value royalty reporting;

c) while MMS may make a reasonable and logical attempt to incorporate marketplace trends and indices into a Determination of Need analysis, the bottom line is that general economic trends cannot reliably confirm or deny an individual refiner's needs; and

d) using the Federal Register as a means of notifying the public of the need to do a determination will frequently not reach the "target audience" of eligible small refiners who generally have neither the access to such notices or the legal review capability typical of the major, integrated companies.

Proposal

We concluded that a proactive, structured, and documented methodology should be established for conducting future determinations. The key elements of the proposed process, with consideration given to the above refiner feedback, include:

1. Issue a Federal Register Notice announcing MMS is seeking input from eligible refiners as part of a Determination of Need. Specific information sought in the Request for Information would include: location of refinery, desirability of OCS versus onshore crude; type of crude desired (e.g., Wyoming Sweet); ability to obtain long-term supply of desired crude (with supporting documentation such as "denial" by major supplier); ability to obtain desired crude at fair market prices (with supporting documentation that desired oil was not equitably priced for the area or region in question); percentage of total refining capacity attibutable to Federal oil versus other sources; "normal" capacity in barrels, and what percentage that is of "total" capacity; "operating capacity" in barrels over the past 12 months, and what percentage that is of normal capacity; etc.

In view of the fact that many refiners do not receive the Federal Register, we will send copies of any Request for Information to all known refiners based on a current mailing list. In addition, we will announce the Determination of Need process and Request for Information to small refiner trade associations and in publications targeted toward the small refiner community.

2. Consult with the Department of Energy, SBA, and/or the Department of Defense (DOD) to discern any national interest or national defense considerations in accordance with regulatory requirement. (For example, DOE and SBA may be able to provide current lists of operating refiners highlighting those considered to be "minority" or "disadvantaged," while DOD (in particular, the Defense Fuel Supply Center) could probably identify small refiners currently supplying military installations with vital jet fuel, heating oil, etc.)

3. Issue a written report of findings and proposed course of action to the Director, MMS. The Director will concur or disapprove the proposed course of action on behalf of the Secretary.

If implemented, ***this proposal would make the process "proactive and methodical,"*** versus the somewhat reactive and inconsistent method employed in the past. It would also create an evidential blueprint for how a Determination of Need is conducted; the results and interpretation of refiner input; and whether the Department deems it necessary to continue the RIK oil program or not based on unbiased, empirical data or other compelling considerations--with the latter conceivably including political or national interest factors.

As the current RIK contracts will expire in June 1999, the Accounting and Reports Division plans to conduct a Determination of Need beginning no later than September 1998.

METHODOLOGY FOR DETERMINING THE RIK ADMINISTRATIVE FEE

Background

The assessment of administrative fees is a discretionary, versus statutory, requirement. Specifically, 30 CFR 208.4 requires that we recover annual RIK program costs through the collection of an administrative fee. The regulation states that first-year costs are to be recovered in part by an initial, upfront contract fee payable in equal installments during the first two months of the contract, with remaining costs to be recovered through monthly variable charges per participating lease. Currently, upon entry into the RIK program, each refiner pays $10,000 each month for the first two months of the first year of the RIK contract. The balance of the annual administrative fee is assessed over the remaining 10 months of the contract year. Subsequent years' costs are recovered through a monthly administrative fee. The administrative fee for each refiner is determined by dividing the annual, recoverable administrative costs by the **total number of <u>leases under contract</u>**.[8]

Prior to adopting the Net Receipts Sharing (NRS) methodology in FY 97, we allocated only direct costs (RIK staff salaries) and some overhead (e.g., computer equipment) to the RIK program when determining the administrative fee cost pool. We based the fee solely on the "active" RIK lease universe (without any consideration for level of effort and other costs associated with "inactive" RIK leases), adjusting it whenever leases were relinquished (dropped from an active contract) or entire contracts terminated. Since the then prevailing interpretation was "full recovery" of estimated annual costs, this invariably meant a larger fee when spreading remaining recoverable costs among a smaller population of active RIK leases. We generally could not satisfactorily explain such increases to refiners whose lease universes remained constant or went down. Their reasonable and fair expectation was, and remains today, that a dwindling lease universe should result in lower administrative fees.

Currently the RIK program's cost pool is based on the NRS methodology which results in a "fully loaded" allocation of overall royalty program costs (both direct and indirect costs) to a given cost center--in this case, RIK. (Under this approach, total recoverable costs for FY 97 were projected to be $1,209,372, resulting in an administrative fee of about $183 per lease per month--$1,209,372 ÷ 549 active leases as of the start of FY 1997 ÷ 12 months.) Under NRS, the total RIK cost pool became significantly larger because it included additional

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[8]The regulation clearly implies that only "active leases"--i.e., those still under contract and, therefore, entitled to royalty oil deliveries--are to be assessed a <u>monthly</u> administrative fee. "Inactive leases," which are terminated leases no longer under contract <u>and</u> undergoing final reconciliation, are not considered when computing the monthly administrative fee.

overhead costs which, heretofore, had not been part of the calculation. Applying the NRS method to the RIK administrative fee calculation process enabled RMP to have one consistent method for legally recovering costs from both RIK refiners and States benefitting from mineral production within their borders.

With the departure of the majority of active leases during FY 97--e.g., Sinclair terminated 224 leases, with 117 of those being deactivated effective sales month January 1997--we decided to "hold fast" with the $183 rate and forego any upward rate adjustments that, in the past, would have occurred commensurate with a changing lease universe. We made this decision in light of Royalty Policy Committee recommendations to review/improve various program elements and perceived inequities with the current method. (**Note**: Had we adjusted the fee commensurate with Sinclair's relinquishments, the monthly assessment would have risen to about $335 effective sales month June 1997, or an 83 percent increase over the $183 rate. Again, we viewed such an increase as ***untenable*** given a) growing concern with certain aspects of the program by the refining community; and, b) the realization that the old calculation methodology failed to account for the flow of program costs pertinent to "inactive" RIK leases--costs which are not properly includable, per regulatory provision, in the administrative fee formula.)

Discussion

To more fully understand the logic behind our proposed new calculation methodology (see Scenario C discussed later), we offer the following ***differing perspectives*** on this issue.

T **Full Cost Recovery From "Active" RIK Leases Only**

- N This essentially is the historic method--i.e., total estimated program costs are allocated solely among active RIK leases when calculating administrative fees, with remaining recoverable costs prorated among remaining active leases upon termination of a lease(s) from the program. No consideration is given to "inactive" RIK leases being reconciled and the costs/level of effort assignable to those leases.

- N Proponents of this perspective argue that anything less than full recovery of all program costs from the active lease universe violates the regulation. Aside from the precedent of "historical practice" (i.e., the paradigm or pattern since program inception has been to do it this way), the regulation at 30 CFR §208.4(b)(4) does

NOT appear to require that all costs, including those attributable to terminated or inactive leases, be spread among only active leases.

T **Recovery of Costs "Related To" Active RIK Leases**

N This approach is based on our strong belief that the regulation does NOT intend that all program costs should be borne only by active leases and contracts. In other words, costs associated with inactive leases should flow in the direction of that effort, while that portion of total costs attributable to active leases should be the only costs factored into the administrative fee equation.

N This approach introduces a ***degree of reasonableness or equity*** lacking in the current approach. We believe this position has merit because it does not countermand the regulation in any way, and would allow for carving up the cost pool based on the ratio of active to inactive leases and assessing administrative fees accordingly.

Over the last several months, we have examined various alternatives to the current method for assessing RIK administrative fees. We have dismissed some of these options as unacceptable, inequitable, and/or administratively burdensome, and, therefore, have not included them in this paper.

Focusing on simplicity and ease of administration, we narrowed our options to include the below (with **Scenario C our recommended approach**):

T **Maintain the FY 1997 $183 Rate - Scenario A**

N This option is presented for comparative purposes only. As discussed in the **BACKGROUND** section above, this reflects the monthly proration of FY 97 NRS costs of about $1.2 million among the active lease universe (549) at the beginning of the fiscal year.

T **Maintain the Historic Approach for the Remaining 212 Active Leases - Scenario B**

N This is a continuation of the historic calculation methodology, using the fully loaded NRS cost pool and prorating that entire cost pool among active leases only.

N This option results in a $496 rate per lease per month, or a 171% increase to the $183 rate charged in FY 97. Active refiners would be billed at a rate nearly 3 times what they experienced in FY 97.

N While this option would be easy to administer, it fails to consider these noteworthy items: resultant and dramatically escalating fees could force remaining refiners out of the program; and all costs continue to be inappropriately assigned only to active leases for purposes of administrative fee calculation. This approach also runs counter to the logical and oft-stated refiner expectation that fees should go down in the context of a diminished lease universe.

T **Cost Pool Adjusted - Scenario C**

N This option "carves up" the NRS cost pool ($1,262,029 for FY 98) on the basis of costs attributable to "active" versus "inactive" RIK leases. Active lease costs are recovered from the refiners, with inactive lease costs assigned to the benefitting State or an offshore account.

N Unlike the historic approach, under which the rate per lease changed when leases were dropped from the program, the rate calculated at the beginning of the fiscal year remains in place throughout the year. This is entirely consistent with the NRS method in which the amount we assess States does not vary as the lease profile or other conditions change during the year.

N This option makes the following key assumptions (the first of which is a restatement of the second "perspective" discussed earlier):

- Since the regulation at 30 CFR 208 requires administrative fee assessment of **leases under contract (i.e, active leases)**, then ***only that portion of the cost pool attributable to active lease work should be factored into the administrative fee computation.*** In other words, active leases should not bear the brunt of the entire cost pool. Direct (i.e., FTE labor) and indirect costs (i.e., overhead) should flow to the leases requiring those expenditures.

- ***The fully loaded NRS calculations are a reasonable representation of annualized RIK costs.*** The NRS methodology has been approved by senior management as an acceptable way of assessing States their share of program costs. Therefore, it should similarly be acceptable for purposes of allocating costs to the RIK program.

The advantages of this option far exceed any real or perceived drawbacks, with one notable disadvantage being the increase to certain onshore States' annual NRS costs by virtue of the re-direction of RIK inactive lease costs to the benefitting States.

Benefits of this approach include: ease of administration (one-time calculation at the beginning of the FY); rate certainty for refiners; consistency with the Department-approved NRS method of allocating costs; greater equity to the refiner by virtue of only including costs assignable to active leases; and more faithful application of cost accounting principles by having level of effort and other indirect costs flow to the appropriate cost center--i.e., costs attributable to active RIK leases figure into the administrative fee calculation, while costs associated with inactive RIK leases flow elsewhere.

We provided a draft version of this Phase II report to senior managers who expressed concurrence with the new approach. As a result, we have implemented the new method effective with the December 1997 RIK billings for sales month October 1997.

(**Note**: During the Eligible Refiner Oil RIK Pilot (targeted for completion in December 1998), we will test various aspects of RIK reporting and accounting. We will review not only processes, but costs associated with those processes. We may prospectively factor it into the equation if the pilot reveals that final reconciliations will have a material cost and that the terms of the contract and the regulations should, therefore, be modified to incorporate recovery of such costs on an estimated basis over the life of the contract.)

USE OF PAYOR SELLING ARRANGEMENTS IN MONTHLY RIK INVOICES

Background

Some of the refiners participating in the current program have complained that they are frequently billed for royalty oil that they do not receive until much later, if at all. Some of these discrepancies are caused by the delivery process (addressed under the Phase I study), while others are caused by the billing process.

The problems that can be traced to the billing process are those involving "estimated billings," or Payor Selling Arrangements (PSEL). These usually are caused when a lessee does not report on an active RIK selling arrangement (SA). When this happens, the Auditing and Financial System generates an estimated volume and value for that SA based on historical amounts, or on an amount estimated prior to the contract. The estimated amount is entered on the bill as a nonrespondent transaction (NR), and is therefore part of the overall billing for that month.

If the lessee later reports on the SA for a month in which an NR was billed, the NR amount is credited on the next bill and the actual entitled amount is billed. However, if the lessee does not subsequently report an actual amount for the SA, the NR is not reversed until later when a reconciliation shows that it was an erroneous billing. The lessee's failure to report can be caused by several things, most notably zero sales not being properly reported for the month in question or invalid SA's that have not been end-dated on the Common Reference Database. Whatever the underlying reason, the refiner that has been billed an erroneous NR loses the use of that billed amount until the reconciliation occurs--sometimes months after the fact.

__Discussion__

The problems inherent to the PSEL process are many and longstanding, and were recently underscored in the FY 97 Alternative Management Control Review (AMCR) conducted by the Office of Enforcement.

For one thing, the PSEL billing amount is an estimated amount based on historical lease production levels that are rarely, if ever, updated. As a result, there's a good chance we would over- or underbill a refiner based on a PSEL estimate--a condition that may not be corrected until much later when we perform a final contract reconciliation. Also, as documented in the referenced AMCR, the costs associated with PSEL generation and maintenance, reference database update, administrative review and verification of production volumes and values, etc., far outweigh any benefits.

Also, the notion that PSEL estimated billings somehow mitigate the Federal Government's exposure or risk of financial loss in the event a refiner stops paying his bills, but continues to receive royalty oil, is a sterile argument given prevailing cash and paper surety requirements. While the AMCR explores this issue as well, it's important to reiterate that the combination of the current 30-day upfront ***estimated payment (cash)*** and the ***surety instrument*** covering 99 days' worth of royalty oil provides the Federal Government with minimum coverage of 120 days (the timeline from refiner nonpayment to operator shutdown of the pipeline) ***plus a 10 percent contingency factor (9 days) for greater-than-normal production levels.***

Proposal

We examined three alternatives (two of which were reviewed under the AMCR):

1) eliminate the PSEL;

2) elevate the PSEL process to the lease, versus SA, level and use it only for the estimated payment to compensate for distribution delays inherent to the transition from in-value to RIK; or

3) implement a "hybrid" of Options 1 and 2 wherein we maintain the current system feature of automatically generating a PSEL estimated billing (or NR billing), but do not allow this amount to flow to the monthly RIK bill if we can ***reasonably*** determine that such action would result in an overbilling to the refiner.

We believe that option 1 is inappropriate because eliminating the PSEL process in its entirety is tantamount to saying that nothing should be billed in the absence of a reported Form MMS-2014 line. In other words, if we adopt option 1, we assume that no report means nothing was delivered to the refiner and, therefore, nothing is owed. Given the "time value of money," this becomes a risky and indefensible premise.

While Option 2 would be less administratively cumbersome than the present SA-based PSEL process, it nevertheless would still require significant effort and resources to implement, i.e., lease level estimates and the initiation and maintenance of PSEL data on the Common Reference Database. Cost-benefit considerations do not favor this approach.

Option 3, while perhaps not an optimal, long-term solution, at least keeps the current system feature of "estimated billing" intact and introduces an important "discretionary" aspect to the process. It would allow us to suppress NR billings if, based on a "reasonableness review" of current reporting and billing activity, we determine that there's a strong likelihood of overbilling the refiner. (Examples of actual or potential overbilling, as a result of an automatic NR billing, include cases where all royalty volume is reported against one lease on a unit agreement, with nothing reported against other active RIK leases within the same unit; or a lease has reverted to in-value reporting, but still reflects as in-kind on the Common Reference Database.) Indications of erroneous NR values would be verified with the reporter prior to issuing RIK bills. In cases where there is no apparent possibility of overbilling, we would allow the system-generated estimated amount to flow to the monthly RIK invoice.

The NPR Reinvention Laboratory commissioned under the Phase I study will test, as one of its key features, the feasibility of refiners reporting and paying royalties based on actual royalty oil deliveries. If successful and implemented, this reporting change would put RIK reporting and paying timelines in sync with in-value royalty timeframes, removing concerns over the time value of money because interest would then be calculated based on sales period instead of RIK invoice due date. In essense, it would eliminate the need for monthly estimated billings--a more desirable, long term solution.

The practice of billing NR's was suspended in June 1997 in recognition that the practice would be evaluated as a part of both this study and the AMCR. With transmittal of this paper, option 3 is formally implemented.